

No. 8263

In the United States Circuit Court of
Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MARIAN OTIS CHANDLER, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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OPINION BELOW

The only previous opinion is that of the United States Board of Tax Appeals (R. 52-60), which is reported in 32 B. T. A. 720.

JURISDICTION

This appeal involves income taxes for the year 1929 in the amount of \$99,683.56, and is taken from an order of redetermination entered July 26, 1935 (R. 60). The appeal is brought by petition for review filed October 19, 1935 (R. 61-73), pursuant to the provisions of the Revenue Act of 1926, c. 27,

44 Stat. 9, 109–110, Sections 1001–1003, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

QUESTION PRESENTED

The Chandis Securities Company was indebted to the taxpayer for interest which had accrued on its promissory notes. The taxpayer offered to accept, and the company agreed to issue to her, its stock to liquidate the indebtedness.

The question is whether ownership of the stock taken in liquidation of the indebtedness became vested in the taxpayer in the year 1929 or in 1930. The answer to that question will determine the year in which the interest income, measured by the agreed fair market value of the stock, is taxable.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.

Regulations 74:

ART. 332. *Income not reduced to possession.*—Income which is credited to the account of or set apart for a taxpayer and

which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

ART. 333. *Examples of constructive receipt.*—When interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. The interest shall be included in gross income even though the coupons are exchanged for other property instead of eventually being cashed. Defaulted coupons are income for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the demand of the shareholder. As to the distributive share of the

profits of a partner in a partnership, see section 182 and article 902. Interest credited on savings bank deposits, even though the bank nominally has a rule, seldom or never enforced, that it may require so many days' notice before withdrawals are permitted, is income to the depositor when credited. * * *

STATEMENT

The facts found by the Board of Tax Appeals are as follows (R. 53-58):

Harry Chandler, in 1916, incorporated the Chandis Securities Company with a capital stock of 500 shares (par value \$1,000 a share), for which stock he transferred to it certain real and personal property. He transferred 200 of such shares to his wife, respondent herein, and 280 shares to his children. Later he transferred other properties to the company for its promissory notes, which he assigned to his wife and children, in approximately the same proportion as their stockholdings. On December 31, 1923, the interest which had accrued on the notes amounted to \$702,049.61. On that day, the Chandis Securities Company issued to the wife and children new notes for the foregoing notes and accrued interest. The accrued interest on the new notes amounted to \$875,008.67 on December 31, 1929.

On October 14, 1929, the board of directors of the company passed a resolution, increasing its capital stock from 500 shares of the par value of \$1,000 per share to 50,000 shares of the par value of \$100

per share. On December 18, 1929, the board of directors of the company passed a resolution authorizing the company's officers to apply to the Corporation Commissioner of the State of California for permission to sell or issue 40,000 shares of its capital stock at par to liquidate the indebtedness of the company to its stockholders. The resolution contained the following recitals and provisions (R. 55-56):

WHEREAS Chandis Securities Company is indebted to the following named persons, to wit:

Marian Otis Chandler
Franceska C. Kirkpatrick
May O. Goodan
Helen Chandler
Philip Chandler
Ruth C. Williamson
Harrison G. Chandler
Constance Chandler
Norman Chandler

in the aggregate principal sum of \$2,640,-598.21, all of which is evidenced by several promissory notes of this company held by said persons, dated December 31st, 1923, due on or before the 31st day of December 1928, which notes bear interest at the rate of 5% per annum, compounded annually, on which no part of said principal or accrued interest has been paid, and

WHEREAS the aforesaid persons have expressed their willingness and have offered to accept stock in this corporation at full

par value thereof in full or part payment of their respective notes together with interest thereon.

NOW, THEREFORE, be it resolved that, subject to the approval of the Commissioner of Corporations of the State of California, this corporation issue to any and/or all of the aforesaid persons in liquidation and payment of all or part of the indebtedness as aforesaid, together with interest thereon accrued to the time of the issuance, fully paid stock in this corporation at its par value for the amount of the indebtedness so liquidated and paid, and that this corporation take and receive from the persons aforesaid a cancellation and satisfaction of said notes to the extent that stock may be so issued to the respective holders thereof.

AND BE IT FURTHER RESOLVED, That the President and Secretary of this Corporation be and they are hereby, authorized and empowered to make application to the Commissioner of Corporations of the State of California, for a permit to sell and/or issue to and/or among the foregoing persons only, and one other, forty thousand shares of the capital stock of this corporation, at par, either

(a) For cash, lawful money of the U. S., and/or

(b) Such amount thereof as may be necessary to pay, liquidate, and discharge not to exceed the amount of the indebtedness to said persons, hereinbefore referred to, for principal and/or interest accrued on said

notes to the time when said stock may be issued.

On December 20, 1929, the company filed such application, which was granted on December 26, 1929. The permit contained the following provision (R. 57) :

1. To issue to any or all of the persons named in its application filed on the 20th day of December, 1929, an aggregate of not to exceed 35,156 shares of its capital stock as consideration for the cancellation of the indebtedness of applicant to them, described in said application; \$100.00 of such indebtedness to be canceled upon the issuance of each of said shares.

By its terms the permit expired December 26, 1931.

On January 2, 1930, the respondent and the children surrendered their notes in exchange for the stock certificates issued by the company that day, and the notes thereupon were canceled. The certificates were actually delivered in May 1930. The canceled notes each bear on the face a receipt signed by the respective former holder as follows (R. 57) : "January 2, 1930. The receipt of capital stock of Chandis Securities Company in full settlement of principal and accrued interest to December 31, 1929 is hereby acknowledged."

From 1924 to 1929, the company accrued interest on the above described notes at 5 per cent per annum and deducted such interest on its income tax

returns. The company kept its books and made its income tax returns on the accrual basis, while the taxpayer and the children kept their books and filed their returns on the cash receipts and disbursements basis. The individuals did not report any interest received in connection with the above notes.

The notes in question were in the custody of Horace Downing, secretary of the company, throughout the year 1929. The balance sheet of the company on December 31, 1929, lists the notes of the taxpayer among its liabilities. The books of the company contain appropriate entries to show that the transactions were consummated in 1930. It was stipulated that the value of the stock of the company was \$60 per share at any time material to this proceeding.

The Commissioner urged that in 1929 the taxpayer received stock in payment of the interest due her, and that, consequently, she was in receipt of interest income in that year to the extent of the market value of such stock. The Board concluded that the taxpayer became owner in 1930 of the stock exchanged for the accumulated interest, and, hence, could not have received any income in 1929. The Commissioner appeals from that determination.

SUMMARY OF ARGUMENT

The Board of Tax Appeals decided that the transaction by which the Chandis Securities Com-

pany paid its indebtedness, consisting of principal and interest, to the taxpayer through the issuance of shares of its capital stock was consummated in 1930, and not in 1929, as determined by the Commissioner of Internal Revenue.

The taxpayer became the owner of the stock on the date of the approval by the State Corporation Commissioner of the permit to issue the stock, i. e., December 26, 1929. The substance of the resolution-contract was the acceptance by the corporation of the taxpayer's offer to take stock in liquidation of the indebtedness, subject to but one condition, that is, the approval by the Corporation Commissioner of the permit, and when that condition was removed the agreement became executed and the rights of the parties became fixed. Such was the clear intention of the parties as evidenced by the agreement.

The Board's position is untenable. The wording of the permit cannot operate to modify the agreement entered into by the parties. Furthermore, we are here dealing with a subscription for stock, and not a sale of stock. In the case of a subscription, the acts of delivery and payment need not necessarily be concurrent.

ARGUMENT

It is the Commissioner's position that the ownership of the stock given in payment for interest due vested in the taxpayer on December 26, 1929, the date when the State Corporation Commissioner

granted the permit to issue the stock. For that reason, the interest income, measured by the agreed market value of the stock, was taxable in the year 1929, and not in a later year.

The Commissioner relies upon the resolution of December 18, 1929 (R. 82-85), to establish the existence of a contract revealing the intention of the parties involved to transfer ownership in the stock on the date the permit to issue was approved. It was upon that date that the taxpayer acquired the stock in the company. To constitute one a stockholder, a valid contract, express or implied, between him and the corporation is essential, and the formation and validity of such contract are governed and determined by the same principles as apply to other contracts. *Hughes Mfg. Co. v. Wilcox*, 13 Cal. App. 22; *Welch v. Gillelen*, 147 Cal. 571. An offer in some form and an acceptance resulting in mutual assent must be present.

These elements are present in the instant case. The resolution on its face is an acceptance of an offer submitted to the corporation by the taxpayer and others to take stock in satisfaction of the indebtedness, the one condition being the approval of the additional stock issue by the State Corporation Commission. That condition was performed on December 26, 1929. The plain import and language of the resolution, which constituted the corporation's acceptance of the offer, conveys no other meaning and establishes the existence of a

binding and enforceable contract upon the performance of the condition. *Water Works Co. v. Holme*, 49 Colo. 412. In the latter case, the rights of the defendant to the stock had, as here, their beginning in a resolution of the board of directors and became fixed when the condition was removed. In *Moore v. Moffatt*, 188 Cal. 1, an agreement to take stock became valid when the only legal obstacle to the making of the contract had been overcome by compliance with the statutory requirement, i. e., the procurement of the permit to issue the stock. When a corporation has agreed that a person shall be entitled to a certain number of shares in its capital to be paid for in a manner agreed upon, and that person has agreed to take and pay for them accordingly, he becomes their owner by a valid contract made upon a valid consideration. *Mitchell v. Beckman*, 64 Cal. 117.

The resolution recites (R. 84):

WHEREAS the aforesaid persons [the stockholders] have expressed their willingness and have offered to accept stock in this corporation at full par value thereof in full or part payment of their respective notes together with interest thereon,

NOW, THEREFORE, be it resolved that, subject to the approval of the Commissioner of Corporations of the State of California, this corporation issue * * * fully paid stock in this corporation at its par value for the amount of the indebtedness so liquidated and paid, and that this corporation take and

receive from the persons aforesaid a cancellation and satisfaction of said notes. * * *

* * * * *

The substance of the resolution-contract between the stockholders and the company was that, upon the approval of the agreement between them by the State Corporation Commissioner, the stockholders were to become the owners of the additional shares and the indebtedness of the corporation to them for principal and interest was to be canceled. The parties predicated their agreements upon the approval of the Corporation Commissioner of the permit to issue the additional stock. Upon the performance of the condition, the additional subscription contained in the offer made by the stockholders became an unconditional and absolute subscription. It was intended the ownership should pass on that day, not on some day selected by the stockholders to complete the mechanics of the sale. As soon as the permit was approved, the contract was fully executed and the rights of the parties became fixed. From that moment the corporation had a right to demand the notes for cancellation; the stockholders had the right to demand the certificates of stock. Any agreement by which a person shows an intention to become a stockholder is sufficient to bind both him and the corporation. *In re Hannevig*, 10 F. (2d) 941 (C. C. A. 2d).

It is immaterial that the stockholders failed to call for and receive their certificates (*Pacific National Bank v. Eaton*, 141 U. S. 227, 233), or even

that their names did not appear on the books of the corporation as owners of the stock (*Early v. Richardson*, 280 U. S. 496), and the date of the cancellation of the notes is no more controlling than the date of the issuance and delivery of the certificates. The stockholders had obligated themselves to deliver the notes for cancellation; the date of the actual cancellation is immaterial. The parties predicated their agreement upon the approval by the Corporation Commissioner of the permit to issue the additional stock. The date of such approval is controlling. *United States Nat. Bank v. Stiller*, 216 Cal. 324.

The stockholders, all members of one family, had complete dominion over the acts of the corporation. In fact, they were the corporation. They owned and controlled it and it acted only when they willed it should act. It was wholly within their power to complete the transaction contemplated under the corporation resolution by issuing the stock, canceling the notes, and by making appropriate entries to show ownership of the stock in themselves. Having failed to do that which they could have done, they may not shift the incidence of ownership to a later year. *Western Pacific Paper Co. v. Hollywood Topics*, 113 Cal. App. 305, 298 Pac. 35. Nor should the taxpayers be permitted, through failure or refusal to accept income, to select the year in which to report it. The income was available to them in the form of stock in 1929; they had a right to reduce it to immediate posses-

sion in 1929. It was, therefore, constructively received by them in 1929. Article 332, Regulations 74, *supra*. *Security First Nat. Bank of Los Angeles v. Commissioner*, 28 B. T. A. 289; *Lewis v. Commissioner*, 30 B. T. A. 318. There is no sound reason for holding that the taxpayer may escape tax through a simple omission to reduce to possession income to which she became unrestrictedly entitled in the taxable year 1929. *A. D. Saenger, Inc. v. Commissioner*, 84 F. (2d) 23 (C. C. A. 5th).

The stock certificate books were in charge of Assistant Secretary Downing during 1929 (R. 118); the notes were in his custody during the same year (R. 139). He was thoroughly familiar with the intentions of the parties to the agreement. He approved a rough draft of the journal entry covering the transactoin reading (R. 224): "J 193-22. To record part payment for subscriptions to stock by cancellation of principal and interest of following notes owing to subscribers as of December 31, 1929." This entry was carried later into the Journal (R. 229), and again the entry is "as of December 31, 1929", obviously indicating it was understood by the parties that the transaction had been fully consummated before the close of the year. It is to be noted that the corporation deducted no interest on the notes in question after 1929 (R. 141). There appears to be no reason why even the mechanics of the exchange, including the pen changes of moving over the decimal point and adding a zero to the amount of capital stock

shown on the old certificates (no new certificates having been printed for the additional issue (R. 141)), could not have been completed before the end of the year to thus record the apparent intention of the parties.

The Board of Tax Appeals construed the permit authorizing the issuance of additional stock as requiring the simultaneous cancellation of the notes and issuance of the stock; that the two acts were mutually dependent and were to coincide in time. The permit authorizing the issuance of the stock reads, in part, as follows (R. 111-112):

1. To issue to any or all of the persons named in its application filed on the 20th day of December 1929, an aggregate of not to exceed 35,156 shares of its capital stock as consideration for the cancellation of the indebtedness of applicant to them, described in said application; \$100.00 of such indebtedness to be cancelled upon the issuance of each of said shares.

Not only is the construction placed upon the wording of the permit strained and unwarranted, but it is also without foundation in law. This Court said, in *Faris v. Helvering*, 71 F. (2d) 610, 611:

Neither the action of the state commissioner of corporations nor of the corporation is decisive of the matter, which is controlled by the Revenue Laws of the United States. * * *

It is plain that the State was interested only in guarding against the use of the additional issue for a purpose other than that stated in the application. In any event, the resolution-contract was a subscription agreement, and not an agreement to buy or sell property. In truth, the transaction is the same as if the company had paid cash to liquidate the indebtedness and the taxpayer had immediately paid in full her subscription for the stock. Cf. *Commissioner v. S. A. Woods Mach. Co.*, 57 F. (2d) 635 (C. C. A. 1st). It is, of course, well established that where the contract constitutes a sale of stock, as distinguished from a subscription, such sale stands like a sale of other property, and, unless otherwise provided, payment and delivery are mutual and concurrent acts and tender must be shown. *Commercial State Bank v. Eilers*, 124 Or. 379. But, in the case of a subscription, the acts of delivery and payment are not necessarily concurrent. *Storage Co. v. Assessors*, 56 N. J. L. 389. In the instant case we have a subscription to an authorized increase in capitalization; a subscription that in no wise differs from a subscription to an original issue. It is always referred to as a subscription. *Stokes v. Continental Trust Co.*, 186 N. Y. 285. As such, it was not necessary that cancellation of the notes and the delivery of the stock be concurrent acts to vest stock ownership in the taxpayer.

CONCLUSION

The decision of the Board should be reversed.

Respectfully,

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OCTOBER 1936.

